BRIEF ON MERITS
No. 255

IN THE

Supreme Court of the United States

OCTOBER TERM 1955

MILLINERY CENTER BUILDING CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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Opinion Below

The opinion of the Court of Appeals (R. 16-19) rendered April 14, 1944, is reported at 221 F. 2d 322. The Findings of Fact and Opinion of the Tax Court of the United States, promulgated February 26, 1954, are reported at 21 T. C. 817 (R. 1-15). Judgment was entered March 22, 1954.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit is dated April 14, 1955 (R. 20). The timely peti-

tion for rehearing to the court below was denied on May 18, 1955. (R. 28). Petition for a writ of certiorari to this court was filed on July 22, 1955 and was granted on October 10, 1955. The jurisdiction of this Court rests on 28 U. S. Code, Section 1254(1). See Rule 19(1)(b).

Questions Presented

1. Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, may the lessee deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under Section 23(a) of the U. S. Internal Revenue Code of 1939 or under Section 23(f) as a loss on a transaction entered into for profit and not compensated for by insurance or otherwise?

2. In the alternative, may the lessee-petitioner consider the excess payment over the determined value of the land to be in the nature of a prepayment of rent for the remaining term of the extinguished lease and amortize such amount over 21 years?

Statutes Involved

Pertinent provisions of the U. S. Internal Revenue Code of 1939, adopted by Act of February 10, 1939, Ch. 2, 53 Stat. 1-504 (as amended by Section 121 of the Revenue Act of 1942, Ch. 619, 56 Stat. 798), applicable to this proceeding are:

"Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or business expenses.

(a) In general. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

"Sec. 23(f) Losses by Corporations.

In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise."

"Sec. 23(l) Depreciation. A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)

(1) of property used in the trade or business, or

(2) of property held for the production of income."

"Sec. 272. Procedure in General.

(a)(1) Petition to the Tax Court of the United States.

If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect to the tax imposed by this chapter, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Tax Court of the United States for a redetermination of the deficiency.***"

* * * * * *

(26 U. S. Code 1952 Ed.)

Statement

The petitioner duly filed its petition for a redetermination of its excess profits tax liability for the calendar year 1945 with the Tax Court of the United States which had jurisdiction over the proceeding in the first instance, in accordance with Section 272(a)(1) of the U. S. Internal Revenue Code of 1939.

The Tax Court of the United States made its findings of fact and rendered its opinion on February 26, 1954 and entered its decision on March 22, 1954, on the basis of the pleadings, oral testimony, arguments and briefs (R. 1-16).

It was determined by the Tax Court of the United States that the lessee-petitioner (the owner of the building on leased land) was not entitled to deduct any part of a payment made by the petitioner to the owner of the land over and above the determined value of the land at the date of purchase of the fee in 1945 to obtain the cancellation of a lease, the rental terms of which were deemed by the petitioner to be excessive; that the payment of $2,100,000 was made by the petitioner for a "bundle of rights", no part of which was amortizable over the remaining term of the extinguished lease or depreciable over the remaining economic life of the building.

The Tax Court of the United States was sustained by the court below in its holding that the excess payment over the determined value of the land of $600,000 was a capital asset which could neither be deducted as an expense or a loss nor could any part of the payment to the landowner be amortized (R. 17-19); but the Circuit Court below agreed with the six dissenting judges of the Tax Court of the United States that the petitioner had made an additional investment in the building which it had a right to depreciate over the remaining economic life of the building (R. 19).

With regard to this latter holding of the court below, the respondent in his memorandum (R. M. 6; 7) states:

> "It is to be observed, however, that the taxpayer prevailed on the third question stated in its petition (Pet. 2)—i.e., it was allowed by the Court of Appeals to depreciate the value of the building over its remaining economic life—and we do not seek review of this determination. Since there is thus no issue here as to the correctness of the decision below on this question, there is no occasion for this Court to reach and review it."

The decision of the Tax Court of the United States was based on the following findings of fact:

On April 30, 1924, petitioner leased land at the northeast corner of Seventh Avenue and 38th Street, New York City, from the landowner. The plot was approximately 100 feet on Seventh Avenue and 200 feet on 38th Street (R. 4).

The lease provided that the petitioner-lessee was to build a 22-story loft building at a cost of $3,000,000, including interest, taxes and insurance during construction on said leased land (R. 4).

Petitioner had to pay a net basic ground rental of $100,000 per annum plus the income taxes thereon (R. 4).

Title to the building, including improvements, additions and fixtures belonged to the petitioner-lessee. Title to the building was to vest in the landlord at the expiration of the last term of the lease, or other sooner termination thereof, at the option of the landlord (R. 4).

In the event of the destruction of the building by fire or other causes, tenant was still liable on the lease and could not abandon the lease (R. 4).

In the event of the destruction, in whole or in part, of the building, the tenant at its own cost had to make the building whole. At the expiration of the lease, or the sooner termination thereof, the petitioner-tenant was to surrender the premises and the building to the landlord at his option, free and clear of any encumbrances, without the landlord being obligated to pay for the property (R. 4).

Petitioner had the option to renew the lease for two successive terms of 21 years each. The ground rent

for the renewal period was to be 6% of the value of the land, vacant and unimproved, at the termination of each period of the lease, but in no event was the rent to be less than the basic net rent of $100,000 plus $18,840 which represents the additional rent in lieu of income tax on such $100,000 (R. 5).

On April 16, 1945, petitioner renewed the ground lease for an additional 21 years. The parties to the lease agreed, and the Tax Court found, that the rental at 6% of the value of the land in April 1945 would have been less than the minimum basic net rental of $100,000 (R. 5).

On May 11, 1945, petitioner purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease at the request of the landlord (R. 5).

The agreement of sale between the Wendel Foundation, lessor and owner of the fee, and petitioner recited among other provisions the price was $2,100,000 and seller shall execute upon request of the purchaser (petitioner) an agreement cancelling and terminating said lease as of the time of the actual closing of title hereunder (R. 5, 6).

The value of the land, vacant and unimproved, upon which the petitioner's property stood was $660,000 when purchased by petitioner in 1945 (R. 8).

Other facts are:

The fair net rental value of the land at the date of purchase in 1945 was between $35,000 and $40,000 per annum (R. 50, 56).

The rental prices of the land in 1924 was 2-1/2 times the values in 1945, the year of the purchase of the property (R. 55).

The original building cost of approximately $3,000,000 was amortized by petitioner over the first 21-year term of the lease which fact is not at issue in this proceeding (R. 14).

ARGUMENT

I.

THE PETITIONER-LESSEE IS ENTITLED TO DEDUCT $1,440,000 OR SOME PART THEREOF INCURRED IN CONNECTION WITH THE CANCELLATION OF A BURDENSOME LEASE AS AN ORDINARY AND NECESSARY EXPENSE UNDER SECTION 23(a) OR AS A LOSS UNDER SECTION 23(f) OF THE U. S. INTERNAL REVENUE CODE OF 1939.

There is no question that the motivating factor for the taxpayer's expenditure of $2,100,000 was to be released from what it deemed to be the burdensome terms of a lease reflected in excessive rent and contingent liabilities that could very well become onerous. Simonson, petitioner's president, made this clear in his testimony (R. 45, 46).

Although this fact was recognized by the Tax Court (R. 5) and it determined from competent and authoritative evidence that the value of the land, vacant and unimproved, was $660,000 in May 1945, it refused to allow any deduction for the excess payment of $1,440,000

($2,100,000 over $660,000). The Tax Court treated the whole transaction as the purchase of a bundle of rights, a capital asset, for which no allocation was possible. The Tax Court did not define what was included in this bundle of rights other than that the bundle included the cancellation of the lease.

The Circuit Court below agreed with the conclusion of the Tax Court that no deduction under Section 23(a) of the U. S. Internal Revenue Code of 1939 was allowable but held the bundle of rights consisted of a reversionary interest in land and building.

The petitioner contends that it bought nothing more for its $2,100,000 than land worth $660,000 and a cancellation of a lease. There were no other rights in the "bundle". Its rights to the actual use and enjoyment of the property under the lease were as complete and as beneficial as after the purchase of the fee. What the petitioner did was to extinguish a number of contingent liabilities and a real liability to pay rent of $118,840 per annum, of which a minimum of $78,000 was excessive. There is no question that petitioner's income was thereafter increased by $118,840 per annum and it is paying income taxes thereon each year.

The Tax Court in support of its findings that petitioner was not entitled to any deduction stated that the bundle of rights was so inextricably entwined in the acquisition of the land that no segregation could be made between the value attributable to the land and the value attributable to the cost of cancelling the lease. The conclusion of the Tax Court was apparently influenced to some extent by the failure of the contract of sale to state separately what

amount was being paid for the land and what amount for the cancellation of the lease. The Tax Court ignored what it should have judicially noted that in practically every case when improved real estate is sold, there is no segregation between the value attributable to land and value attributable to other assets. The courts have recognized that for tax purposes a single payment may include an amount for the purchase of an asset and the payment of an expense, and if the expense is ordinarily a deductible item, the fact that it was included in an aggregate transaction will not affect its allowance. *Lomas & Nettleton Co. v. U. S.*, 79 F. Supp. 886 (D. Conn. 1948); *The Stuart Co. v. Commissioner*, Memo T. C. Op. Docket 12473, Aff'd (C. A. 9, 1952) 195 F. 2d 170; *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F. 2d 805 (C. A. 6, 1948).

The error of the Tax Court and the court below in refusing to allow the payment of $1,440,000 as a deduction was due to their failure to recognize that the right to excess ground rents is a property right, separate and apart from the land itself. However, in a recent decision of *Mary Young Moore v. Commissioner*, August 5, 1955, the Tax Court, upon remand of the case from the U. S. Court of Appeals, 207 F. 2d 265 (C. A. 9, 1953), recognized for the first time that a total value for land and leasehold may be broken up into its component parts. In that case the inherited value of a fee estate subject to a long-term lease was determined to be in excess of the basic land value. The U. S. Court of Appeals, Ninth Circuit, in a well reasoned opinion held that the taxpayer's right to receive rents based on 1924 values, the date the lease was negotiated, which were in excess of rent values when the fee was ac-

quired, was a property right which should be amortized over the period the excess rentals would be received.

The economic sameness of this opinion is manifest in the following illustration. Assume F. W. Woolworth Co. is the tenant under a long-term leasehold with 10 years still to run, calling for an annual rent of $50,000. Further, assume the neighborhood has so changed since the lease was negotiated that the area is no longer profitable—even a ghost area. The basic land value at current market prices is only $60,000 but because of future aggregate rental income of $500,000 for the ensuing 10-year period, the land can be sold for $400,000. Such a purchaser is buying a financial transaction and not just land. To properly reflect the economics of the transaction, he should and would allocate $60,000 to land and $340,000 to leasehold (arising from future excess rental income) and amortize said $340,000 over a 10-year period. Thus, his net annual income would be $16,000 ($50,000 rent less $34,000 amortization) on a true land investment of $60,000, and a total average investment of $230,000 ($60,000 + ½ of $340,000). If the total price of $400,000 were considered land, the purchaser would be paying taxes on $50,000 income each year and at the end of 10-year term, when the lease expired and no tenant was available, he would have a piece of property worth only $60,000 with a cost basis of $400,000 and no income to offset the loss against. Certainly, such a result is not in accord with the realities of the situation.

It is probably this reasoning which led the Circuit Court in *Mary Young Moore v. Commissioner, supra*, to hold:

> "The lease, or rather the portion thereof providing the above normal rents, is an intangible asset with a definitely limited life * * *

> * * * if taxpayer could prove, the extent to which the lease was 'favorable', or, what part of the rents are above normal, it should be feasible to ascertain the amount of the purchase price which represented a premium for the favorable aspects of the lease. Such would be no more difficult than the ascertainment of the proper basis for depreciation in the ordinary case where a purchaser buys a lot with a building thereon, all for a lump sum."

Upon remand, the Tax Court (Docket Nos. 17207 & 19383) did determine a value for the excess rentals and permitted the taxpayer to amortize said value over the remaining life of the lease.

The Supreme Court itself, in *Hort* v. *Commissioner of Internal Revenue* (1941), 313 U. S. 28, has recognized that it is possible to value realty and leasehold (arising from excess rentals) separately, when it stated "it might have been possible in such a case to value realty and lease separately and to label each a capital asset."

The position of the petitioner in this proceeding is the contra to that of a purchaser of land with an unduly favorable lease or excess rentals. It follows that what is an unduly favorable lease from excess rents and thus an asset to recipient of the rents must be an unfavorable or burdensome lease and a detriment to the lessee caught on the terms of said lease negotiated many years before under different economic circumstances. The purchaser of land with such a lease thereon is going to reap an advantage over the term of the lease and thus should capitalize this advantage (an intangible property right) and amortize it over the period of the lease. However, a lessee, as in the instant proceeding, buying the land is not acquiring any future

rent income; he is getting out from under an excessive obligation, a definite business purpose, and should be entitled to deduct an expenditure for such a purpose as an ordinary and necessary business expense in the year incurred.

This petitioner should not be treated the same as a person who never had an interest in the property and first acquired land subject to a leasehold. Prior to this purchase in 1945, the taxpayer had invested $3,000,000 in improvements. Any outsider purchasing the interest of the landowner in 1945 would not have had such prior investment in the property. This petitioner had the right to receive all the rents from the property subject only to its obligation to pay operating expenses and the ground rent of $118,840. An outsider acquiring the landowner's interest would not have had the right to collect the rents from the improvement nor would he be obligated to pay the $118,840 net ground rent.

The fact that petitioner had renewed its lease shortly before buying the fee does not establish the fairness of the rent being paid or the value of the land to petitioner. Petitioner had to renew at the excessive rent in order to sustain its economic rights to the leasehold, which were substantial. The building which petitioner owned, costing three million dollars, had a remaining economic life of 30-years and it was not possible for petitioner to take it away. That the rent was excessive in 1945 was testified to at the Tax Court hearing by most competent and creditable witnesses. (R. 47-56). No contrary evidence on that point was introduced by respondent. In fact, the petitioner and its landlord when renewing the lease in 1945, agreed that no appraisal of the land in 1945 (upon which appraisal the net annual rent was to be based at a 6% value) need be made since such a com-

puted rent would be less than the minimum guaranteed basic net rent of $100,000 per annum. (R. 5.)

The U. S. Court of Appeals, Sixth Circuit, had a similar question before it in *Cleveland-Allerton Hotel, Inc. v. Commissioner of Internal Revenue, supra,* and recognizing that taxation is a practicable matter, went to the essence of the transaction and sustained the taxpayer. See also *The Stuart Co. v. Commissioner,* Memo T. C. Op. Docket 12473, aff'd 195 F. 2d 176 (C. A. 9, 1952) in which the courts permitted the taxpayer to allocate a lump sum payment in part to the purchase of trademark and copyrights and in part to the cancellation of an unfavorable supply contract from the same vendor, and allowed a deduction under Section 23(a) of the Internal Revenue Code of 1939 for the amount allocated to the cancellation of the contract.

In *Hort v. Commissioner of Internal Revenue* (1941), 313 U. S. 28, a landlord received a sum of money from a tenant who found it unprofitable to occupy the premises and desired to cancel the lease, which had approximately 14 years more to run. In reviewing the facts and the issues involved, the Supreme Court concluded that the taxpayer had to report as income the entire amount received for the cancellation of the lease since the cancellation involved nothing more than the relinquishment of the right to future rental payments in return for a present substitute payment and possession of leased premises. The Court recognized that the taxpayer's rental income would be less in the future but pointed out that to that extent the taxpayer was relieved of the duty to pay income taxes.

The position of the Millinery Center Building Corp. in the instant case is the converse of that of the taxpayer Hort. It is in the position of the tenant who has made the

payment to save the rental expense, will be paying additional income taxes on the increased income effected by such savings in rent, and should be allowed a deduction for the payment to cancel the lease. Although land was acquired at the same time, it is being paid for at full value in the amount of $660,000.

A contributing factor to the error in the opinions of both courts below was their disregard of a basic principle that the tax consequences of any transaction must be determined from the view of the particular taxpayer entering into the transaction. Thus, in *Western Wine & Liquor Co. v. Commissioner*, 18 T. C. 1090, a wholesale liquor dealer purchased some shares of American Distilling Co. which was offering its shareholders the right to purchase whiskey inventory at cost. After exercising these rights, the taxpayer sold the stock at a loss. The Tax Court, emphasizing that the taxpayer purchased the American Distilling Co. stock not as an investment in stock but only to acquire more whiskey to replenish its inventories in order to sustain its business, held that the difference between the cost of the stock and the selling price represented additional cost of the whiskey acquired. Certainly the vendor of the American Distilling Co. stock was selling his entire interest in the stock and all the rights that accrued therein to the taxpayer but, the Tax Court did not bottom its decision on such fact but on the intent of the vendee taxpayer. An appeal from this decision to the U. S. Court of Appeals, Eighth Circuit, was dismissed, 205 F. 2d 420. To the same effect are the decisions of *Bagley & Sewall*, 20 T. C. 983, aff'd 221 F. 3d 944 (C. A. 2, 1955); *Helvering v. Community Bond & Mortgage Corporation*, 74 F. 2d 727, (C. A. 2, 1935); *Roscoe v. Commissioner*, 215 F. 2d 478, (C. A. 2, 1954). While

the latter case is the contra to that of the petitioner, the principle is the same. In that case two stockholders sold all their holdings in a real estate corporation with which the corporation's stockholders had an exclusive contract to sell the real estate subdivision. The amount received for the stock was in excess of the actual value of the real estate. While the sale contract was for a unitary amount, the taxpayers agreed as part of the contract to cancel their agreement of exclusive agency. The Circuit Court upheld the Tax Court in taxing as ordinary income that part of the selling price in excess of the value of the stock. The Court was of the opinion that whether the excess amount represented compensation for services or payment for cancellation of an undesirable contract it would be ordinary income to the recipient. Thus the Court looked through the form of the unit sales price to get to the substance and sustained an allocation between the amount received for the actual value of the asset being sold and for services or cancellation of the contract.

This principle of determining the taxability of transactions from the intent of the particular taxpayer entering into the transaction has also been recognized in tangible property and real estate transactions. Thus, in *Olympia Harbor Lumber Co.* v. *Commissioner*, 30 B. T. A. 114 (1934), the taxpayer paid $7,900 to acquire certain equipment owned by the vendor with a value not in excess of $2,500, and with the purchase of said equipment a contract between the taxpayer and the vendor was automatically terminated though not specifically stated. The difference of $5,400 was considered to be paid to rid the purchaser of an unsatisfactory contract and the deduction was allowed.

Similarly, there is a line of cases dealing with the acquisition of the stock of a company in order to acquire real estate and other assets, holding that although the stock was what was actually acquired, and all the rights inherent thereto, the intent was to acquire the assets behind the stock and the amount paid for the stock was allocated to the real estate and other assets. In this category are the leading cases of *Prairie Oil & Gas Co.* v. *Motter*, 66 F. 2d 309, (C. A. 10, 1933); *Commissioner* v. *Ashland Oil & Refining Co.*, 99 F. 2d 588 (C. A. 6, 1938); Cert. Den. 306 U. S. 661.

The court below in failing to recognize that the value of excess rentals, based upon economic conditions no longer prevailing, may be apart from actual current land values, and that the intent of a taxpayer is the very core of the substance of a transaction, determined that the Millinery Center Building Corporation had merely acquired the equivalent of the "share of a co-owner or an over-riding easement, or a piece of land next door." In support of this opinion, the court below cited the cases of *Post* v. *Commissioner*, 109 F. 2d 135 (C. A. 2, 1940); *Herzberg* v. *Alexander*, D. C. W. D. Okla. 5 F. Supp. 334 (1933) and *Boos* v. *Commissioner*, 30 B. T. A. 882 (1934).

These decisions referred to by the court below are not in point in that each pertains either to a taxpayer who was already a fee owner or a taxpayer who had acquired the lease interest as an investment; whereas, in the instant proceeding, the Millinery Center Building Corporation already owned the building, had a lease on the land, enjoyed the income therefrom and did not have to make any current payment to acquire an investment in the lease.

In *Post* v. *Commissioner*, supra, the taxpayer was the owner of the land, who at the same time had a leasehold interest arising from the tenant's destruction of an old

building on his property in order to put up a new one. A few years later the tenant's interest was sold on foreclosure to a new company, all of whose stock and securities were received by the landlord, the landlord transferring his fee property to the new corporation. Here the landlord had not paid any amount to anyone and the accounting item of leasehold together with the land were merely transferred to the new company in exchange for the stock. There was no actual loss to deduct.

In *Herzberg* v. *Alexander*, supra, the taxpayer had purchased the unexpired lease for 8 years and 9 months of an original 10-year lease from the tenant for $5,000. In the *very next year*, the taxpayer purchased the land and building from the owners for $63,500. Where a taxpayer pays a lessee a sum of money to take over a lease and within a short period of time acquires the fee, it is obvious that the lease is not burdensome but favorable to the tenant. Then the property, sold subject to a lease favorable to the tenant and consequently less favorable to the landlord, would probably command less than the actual value of land and building and the addition of the lease payment to the property cost would tend to compensate for this fact and give the fair market value.

To illustrate: property is leased at $10,000 per annum for a period of 20 years but after 5 years the rental value of the property increased to $20,000 per annum. Because of the favorable low rent of $10,000 per annum, the tenant could sell his leasehold interest for $100,000. The landlord, however, subject to the low rent of $10,000 per annum, instead of the fair rental value of $20,000, finds that he can only receive $200,000 for his land because of the un-

favorable lease, rather than the $300,000 his land is worth based on land values surrounding his property. Now, if the new lessee, who has paid $100,000 to acquire the leasehold interest, purchases the land for $200,000, it would obviously be unjust and improper to allow him to write off that $100,000. That $100,000 is more properly added to the $200,000 purchase price to arrive at the actual value of the property purchased.

That is not the case in the instant proceeding where the tenant paid a sum of money to save paying excessive rent as well as being relieved from other onerous lease terms and where the Tax Court has found as a fact that the actual value of the land is only $660,000 instead of $2,100,000 paid.

In *Boos v. Commissioner*, supra, the taxpayer in 1927 acquired, at a cost of $25,000, a 99-year lease with *option to purchase*, and in the *very next year* exercised the option and acquired the remaining interest. The facts in *Boos* indicate that the entire transaction can be considered one continuing transaction, making the taxpayer's cost the initial $25,000 and the $55,000 paid in the next year. Furthermore, when a taxpayer pays $25,000 to acquire a lease, it cannot very well argue that the lease was burdensome and the purchase of the property within a year, under the option, was to effect the cancellation of the lease.

The error of the court below is further evident when its decision is put to the test of practical application. That court said that what petitioner bought was a reversionary interest in land as well as building. Petitioner's lease had 21 years to run and the present value of a reversionary interest in land (21 years later) which land is currently

worth $660,000, would not be in excess of $200,000, allowing for a 6% discount rate. This would leave a $1,900,000 present value for a reversionary interest 21 years later of a building which would then have only a 9-year remaining life—a result hardly in accord with the economic facts.

If the renewed lease had been for a period of 42 years (balance of the term under the original lease) there would be no reversionary value for a building with a remaining life of 30 years. Then, land, vacant and unimproved with a present value of $660,000, would, by the force of arithmetic, suddenly have a reversionary value (42 years off) of $2,100,000 under the decision of the court below. The difference in value could not be attributed to the building thereon for that would be of no value, the economic life being 30 years. As a matter of fact, a reversionary interest is obviously worth less than a current whole interest, which the Tax Court conclusively found to be $660,000 for the land. There can be no doubt that the decision of the court below is not in accord with the realities of the situation.

Further illustrating the incongruities arising from the Circuit Court's decision is the following:

> For simplication, let us assume an equal life of lease and building (eliminating the arithmetic of a 9-year overlap in building value). A third party purchaser of the land subject to the lease, not acquiring any building, would have a $660,000 cost for land and $1,440,000 cost for leasehold, but the tenant (already owning the building) buying the fee is not acquiring a leasehold and since the reversionary interest of the building would be zero, would have a cost basis of $2,100,000 for the land if no deduction were allowed for that part of

the payment in excess of the value of the land. So the same land valued at $600,000 to one taxpayer would be valued at $2,400,000 to another taxpayer.

Petitioner contends that the amount to be allowed as a deduction in 1945 under Section 23(a) or (f) of the Internal Revenue Code of 1939 is $1,440,000. The court below erred when it inferred that the value to be attributed to the land must consider the building thereon for the purpose of determining the amount of the excess payment at the time the fee was purchased in 1945.

If one buys land for $600,000 and constructs thereon a building costing $3,000,000, there is no requirement to revalue the land and transfer part of the building cost thereto, and reduce the building cost accordingly.

Similarly, should this property be sold to another entity at a price of $3,660,000 immediately after the completion of the building, the basis to the purchaser would most certainly be $660,000 for the land and $3,000,000 for the building.

The petitioner submits that any value attributed to the land because of a building erected thereon makes the land a wasting asset, which is not contemplated by the Internal Revenue Code. There is no question that the building will eventually be of no economic value and therefore the land some day will be worth only the value of the land without any offsetting value for a building. To attribute an increased value to the land because of such a condition and not permit depreciation thereon means a taxpayer has a wasting asset, concurrent with the depreciation of the building, which is not going to be recovered taxwise. This is contrary to every accounting principle and to the very meaning of Section

23(1) of the Internal Revenue Code of 1939 and the Regulations promulgated thereunder.

The foregoing illustrates the fallacy of the thinking of the court below. Furthermore, it must be evident that a value of $660,000 for a piece of land 100 ft. by 200 ft. takes into consideration the use to which such land is put. Only an adequate improvement to be made would justify such a price of $6,600 per front foot.

If the reiterated admonition of the Supreme Court that "one of the basic aspects of the Federal income tax is that there be an annual accounting of income" is to have validity, the petitioner's payment of $1,440,000 must be deductible in 1945 and in no other year. *Healy* v. *Commissioner of Internal Revenue*, (1953) 345 U. S. 278; *Reo Motors, Inc.* v. *Commissioner of Internal Revenue*, (1950) 338 U. S. 442; *Heiner* v. *Mellon*, (1938) 304 U. S. 271.

II.

ALTERNATIVELY TO THE FIRST ISSUE, THE PETITIONER-LESSEE IS ENTITLED TO AMORTIZE THE EXCESS OF THE PAYMENT OF $2,100,000 OVER THE DETERMINED VALUE OF THE LAND OF $660,000 OVER THE REMAINING TERM OF THE EXTINGUISHED LEASE, A PERIOD OF 21-YEARS.

If the petitioner is in error in its contention that the excess of the payment of $2,100,000 over the determined value of the land of $660,000 was just to rid itself of an obligation (which does not give rise to any asset) and is an allowable deduction in the year of payment, it must follow that the payment has given the taxpayer some financial rights or interest it did not have before, and that this fi-

nancial interest arising from the cancellation of the lease will benefit the petitioner's earnings during the next 21 years by eliminating a recurring rent expense of $118,840 per annum and then be exhausted.

The land investment of $660,000 entitled the petitioner to a rent saving of between $35,000 and $40,000 per year (fair rental value). The saving of the balance of approximately $80,000 per annum as well as the elimination of substantial contingent liabilities were effected by the payment of $1,440,000. This payment is similar to or in the nature of prepaid rent which item unquestionably would be deductible in the years applicable. Treating this payment in such a manner reflects true economic income from the property each year and is in accord with sound accounting practices.

Whether the excess payment of $1,440,000 be designated as prepaid rent or a capital investment, there is no question that said amount does represent a financial interest which will be consumed in benefits over the period of 21 years. As the Supreme Court stated, in *Detroit Edison Co. v. Commissioner of Internal Revenue*, (1943) 319 U. S. 98:

> "The end and purpose of it all (depreciation) is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of its capital assets. For this purpose, it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time it is retired, will with its salvage value replace the original investment therein."

The Courts in varying instances have accepted the principle of amortizing a payment over the period benefited although the payment effected the termination of an interest